

the land is \$60,000. The value of the remainder interest, and thus the amount eligible for an income tax deduction under section 170(f), is computed pursuant to § 1.170A-12. See § 1.170A-12(b)(3).

Example 9. D owns property with a basis of \$20,000 and a fair market value of \$80,000. D donates to a qualifying organization an easement for conservation purposes that is determined under this section to have a fair market value of \$60,000. The amount of basis allocable to the easement is \$15,000 (\$60,000/\$80,000=\$15,000/\$20,000). Accordingly, the basis of the property is reduced to \$5,000 (\$20,000 minus \$15,000).

Example 10. E owns 10 one-acre lots that are currently woods and parkland. The fair market value of each of E's lots is \$15,000 and the basis of each lot is \$3,000. E grants to the county a perpetual easement for conservation purposes to use and maintain eight of the acres as a public park and to restrict any future development on those eight acres. As a result of the restrictions, the value of the eight acres is reduced to \$1,000 an acre. However, by perpetually restricting development on this portion of the land, E has ensured that the two remaining acres will always be bordered by parkland, thus increasing their fair market value to \$22,500 each. If the eight acres represented all of E's land, the fair market value of the easement would be \$112,000, an amount equal to the fair market value of the land before the granting of the easement ($8 \times \$15,000 = \$120,000$) minus the fair market value of the encumbered land after the granting of the easement ($8 \times \$1,000 = \$8,000$). However, because the easement only covered a portion of the taxpayer's contiguous land, the amount of the deduction under section 170 is reduced to \$97,000 (\$150,000-\$53,000), that is, the difference between the fair market value of the entire tract of land before (\$150,000) and after ($(8 \times \$1,000) + (2 \times \$22,500)$) the granting of the easement.

Example 11. Assume the same facts as in example (10). Since the easement covers a portion of E's land, only the basis of that portion is adjusted. Therefore, the amount of basis allocable to the easement is \$22,400 ($(8 \times \$3,000) \times (\$112,000 / \$120,000)$). Accordingly, the basis of the eight acres encumbered by the easement is reduced to \$1,600 (\$24,000-\$22,400), or \$200 for each acre. The basis of the two remaining acres is not affected by the donation.

Example 12. F owns and uses as professional offices a two-story building that lies within a registered historic district. F's building is an outstanding example of period architecture with a fair market value of \$125,000. Restricted to its current use, which is the highest and best use of the property without making changes to the facade, the building and lot would have a fair market value of \$100,000, of which \$80,000 would be allocable

to the building and \$20,000 would be allocable to the lot. F's basis in the property is \$50,000, of which \$40,000 is allocable to the building and \$10,000 is allocable to the lot. F's neighborhood is a mix of residential and commercial uses, and it is possible that F (or another owner) could enlarge the building for more extensive commercial use, which is its highest and best use. However, this would require changes to the facade. F would like to donate to a qualifying preservation organization an easement restricting any changes to the facade and promising to maintain the facade in perpetuity. The donation would qualify for a deduction under this section. The fair market value of the easement is \$25,000 (the fair market value of the property before the easement, \$125,000, minus the fair market value of the property after the easement, \$100,000). Pursuant to § 1.170A-14(h)(3)(iii), the basis allocable to the easement is \$10,000 and the basis of the underlying property (building and lot) is reduced to \$40,000.

(i) **Substantiation requirement.** If a taxpayer makes a qualified conservation contribution and claims a deduction, the taxpayer must maintain written records of the fair market value of the underlying property before and after the donation and the conservation purpose furthered by the donation and such information shall be stated in the taxpayer's income tax return if required by the return or its instructions. See also § 1.170A-13(c) (relating to substantiation requirements for deductions in excess of \$5,000 for charitable contributions made after 1984), and section 6659 (relating to additions to tax in the case of valuation overstatements).

(j) **Effective date.** Except as otherwise provided in § 1.170A-14(g)(4)(ii), this section applies only to contributions made on or after December 18, 1980.

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§ 1.171-1 Bond premium.

(a) **Overview—(1) In general.** This section and §§ 1.171-2 through 1.171-5 provide rules for the determination and amortization of bond premium by a holder. In general, a holder amortizes bond premium by offsetting the interest allocable to an accrual period with the premium allocable to that period. Bond premium is allocable to an accrual period based on a constant yield.

The use of a constant yield to amortize bond premium is intended to generally conform the treatment of bond premium to the treatment of original issue discount under sections 1271 through 1275. Unless otherwise provided, the terms used in this section and §§ 1.171-2 through 1.171-5 have the same meaning as those terms in sections 1271 through 1275 and the corresponding regulations. Moreover, unless otherwise provided, the provisions of this section and §§ 1.171-2 through 1.171-5 apply in a manner consistent with those of sections 1271 through 1275 and the corresponding regulations. In addition, the anti-abuse rule in § 1.1275-2(g) applies for purposes of this section and §§ 1.171-2 through 1.171-5.

(2) *Cross-references.* For rules dealing with the adjustments to a holder's basis to reflect the amortization of bond premium, see § 1.1016-5(b). For rules dealing with the treatment of bond issuance premium by an issuer, see § 1.163-13.

(b) *Scope*—(1) *In general.* Except as provided in paragraph (b)(2) of this section and § 1.171-5, this section and §§ 1.171-2 through 1.171-4 apply to any bond that, upon its acquisition by the holder, is held with bond premium. For purposes of this section and §§ 1.171-2 through 1.171-5, the term *bond* has the same meaning as the term *debt instrument* in § 1.1275-1(d).

(2) *Exceptions.* This section and §§ 1.171-2 through 1.171-5 do not apply to—

(i) A bond described in section 1272(a)(6)(C) (regular interests in a REMIC, qualified mortgages held by a REMIC, and certain other debt instruments, or pools of debt instruments, with payments subject to acceleration);

(ii) A bond to which § 1.1275-4 applies (relating to certain debt instruments that provide for contingent payments);

(iii) A bond held by a holder that has made a § 1.1272-3 election with respect to the bond;

(iv) A bond that is stock in trade of the holder, a bond of a kind that would properly be included in the inventory of the holder if on hand at the close of the taxable year, or a bond held primarily for sale to customers in the or-

dinary course of the holder's trade or business; or

(v) A bond issued before September 28, 1985, unless the bond bears interest and was issued by a corporation or by a government or political subdivision thereof.

(c) *General rule*—(1) *Tax-exempt obligations.* A holder must amortize bond premium on a bond that is a tax-exempt obligation. See § 1.171-2(c) *Example 4*.

(2) *Taxable bonds.* A holder may elect to amortize bond premium on a taxable bond. Except as provided in paragraph (c)(3) of this section, a taxable bond is any bond other than a tax-exempt obligation. See § 1.171-4 for rules relating to the election to amortize bond premium on a taxable bond.

(3) *Bonds the interest on which is partially excludable.* For purposes of this section and §§ 1.171-2 through 1.171-5, a bond the interest on which is partially excludable from gross income is treated as two instruments, a tax-exempt obligation and a taxable bond. The holder's basis in the bond and each payment on the bond are allocated between the two instruments based on a reasonable method.

(d) *Determination of bond premium*—(1) *In general.* A holder acquires a bond at a premium if the holder's basis in the bond immediately after its acquisition by the holder exceeds the sum of all amounts payable on the bond after the acquisition date (other than payments of qualified stated interest). This excess is bond premium, which is amortizable under § 1.171-2.

(2) *Additional rules for amounts payable on certain bonds.* Additional rules apply to determine the amounts payable on a variable rate debt instrument, an inflation-indexed debt instrument, a bond that provides for certain alternative payment schedules, and a bond that provides for remote or incidental contingencies. See § 1.171-3.

(e) *Basis.* A holder determines its basis in a bond under this paragraph (e). This determination of basis applies only for purposes of this section and §§ 1.171-2 through 1.171-5. Because of the application of this paragraph (e), the holder's basis in the bond for purposes of these sections may differ from the holder's basis for determining gain or

loss on the sale or exchange of the bond.

(1) *Determination of basis*—(i) *In general.* In general, the holder's basis in the bond is the holder's basis for determining loss on the sale or exchange of the bond.

(ii) *Bonds acquired in certain exchanges.* If the holder acquired the bond in exchange for other property (other than in a reorganization defined in section 368) and the holder's basis in the bond is determined in whole or in part by reference to the holder's basis in the other property, the holder's basis in the bond may not exceed its fair market value immediately after the exchange. See paragraph (f) *Example 1* of this section. If the bond is acquired in a reorganization, see section 171(b)(4)(B).

(iii) *Convertible bonds*—(A) *General rule.* If the bond is a convertible bond, the holder's basis in the bond is reduced by an amount equal to the value of the conversion option. The value of the conversion option may be determined under any reasonable method. For example, the holder may determine the value of the conversion option by comparing the market price of the convertible bond to the market prices of similar bonds that do not have conversion options. See paragraph (f) *Example 2* of this section.

(B) *Convertible bonds acquired in certain exchanges.* If the bond is a convertible bond acquired in a transaction described in paragraph (e)(1)(ii) of this section, the holder's basis in the bond may not exceed its fair market value immediately after the exchange reduced by the value of the conversion option.

(C) *Definition of convertible bond.* A convertible bond is a bond that provides the holder with an option to convert the bond into stock of the issuer, stock or debt of a related party (within the meaning of section 267(b) or 707(b)(1)), or into cash or other property in an amount equal to the approximate value of such stock or debt.

(2) *Basis in bonds held by certain transferees.* Notwithstanding paragraph (e)(1) of this section, if the bond is transferred basis property (as defined in section 7701(a)(43)) and the transferor had acquired the bond at a pre-

mium, the holder's basis in the bond is—

(i) The holder's basis for determining loss on the sale or exchange of the bond; reduced by

(ii) Any amounts that the transferor could not have amortized under this paragraph (e) or under § 1.171-4(c), except to the extent that the holder's basis already reflects a reduction attributable to such nonamortizable amounts.

(f) *Examples.* The following examples illustrate the rules of this section:

Example 1.

Bond received in liquidation of a partnership interest—(i) *Facts.* PR is a partner in partnership PRS. PRS does not have any unrealized receivables or inventory items as defined in section 751. On January 1, 1998, PRS distributes to PR a taxable bond, issued by an unrelated corporation, in liquidation of PR's partnership interest. At that time, the fair market value of PR's partnership interest is \$40,000 and the basis is \$100,000. The fair market value of the bond is \$40,000.

(ii) *Determination of basis.* Under section 732(b), PR's basis in the bond is equal to PR's basis in the partnership interest. Therefore, PR's basis for determining loss on the sale or exchange of the bond is \$100,000. However, because the distribution is treated as an exchange for purposes of section 171(b)(4), PR's basis in the bond is \$40,000 for purposes of this section and §§ 1.171-2 through 1.171-5. See paragraph (e)(1)(ii) of this section.

Example 2. Convertible bond—(i) *Facts.* On January 11, 1998, A purchases for \$1,100 B corporation's bond maturing on January 1, 2001, with a stated principal amount of \$1,000, payable at maturity. The bond provides for unconditional payments of interest of \$30 on January 1 and July 1 of each year. In addition, the bond is convertible into 15 shares of B corporation stock at the option of the holder. On January 1, 1998, B corporation's nonconvertible, publicly-traded, three-year debt with a similar credit rating trades at a price that reflects a yield of 6.75 percent, compounded semiannually.

(ii) *Determination of basis.* A's basis for determining loss on the sale or exchange of the bond is \$1,100. As of January 1, 1998, discounting the remaining payments on the bond at the yield at which B's similar nonconvertible bonds trade (6.75 percent, compounded semiannually) results in a present value of \$980. Thus, the value of the conversion option is \$120. Under paragraph (e)(1)(iii)(A) of this section, A's basis is \$980 (\$1,100-\$120) for purposes of this section and §§ 1.171-2 through 1.171-5. The sum of all amounts payable on the bond other than qualified stated interest is \$1,000. Because

A's basis (as determined under paragraph (e)(1)(iii)(A) of this section) does not exceed \$1,000, A does not acquire the bond at a premium.

[T.D. 8746, 62 FR 68177, Dec. 31, 1997]

§ 1.171-2 Amortization of bond premium.

(a) *Offsetting qualified stated interest with premium*—(1) *In general.* A holder amortizes bond premium by offsetting the qualified stated interest allocable to an accrual period with the bond premium allocable to the accrual period. This offset occurs when the holder takes the qualified stated interest into account under the holder's regular method of accounting.

(2) *Qualified stated interest allocable to an accrual period.* See § 1.446-2(b) to determine the accrual period to which qualified stated interest is allocable and to determine the accrual of qualified stated interest within an accrual period.

(3) *Bond premium allocable to an accrual period.* The bond premium allocable to an accrual period is determined under this paragraph (a)(3). Within an accrual period, the bond premium allocable to the period accrues ratably.

(i) *Step one: Determine the holder's yield.* The holder's yield is the discount rate that, when used in computing the present value of all remaining payments to be made on the bond (including payments of qualified stated interest), produces an amount equal to the holder's basis in the bond as determined under § 1.171-1(e). For this purpose, the remaining payments include only payments to be made after the date the holder acquires the bond. The yield is calculated as of the date the holder acquires the bond, must be constant over the term of the bond, and must be calculated to at least two decimal places when expressed as a percentage.

(ii) *Step two: Determine the accrual periods.* A holder determines the accrual periods for the bond under the rules of § 1.1272-1(b)(1)(ii).

(iii) *Step three: Determine the bond premium allocable to the accrual period.* The bond premium allocable to an accrual period is the excess of the qualified stated interest allocable to the accrual period over the product of the holder's

adjusted acquisition price (as defined in paragraph (b) of this section) at the beginning of the accrual period and the holder's yield. In performing this calculation, the yield must be stated appropriately taking into account the length of the particular accrual period. Principles similar to those in § 1.1272-1(b)(4) apply in determining the bond premium allocable to an accrual period.

(4) *Bond premium in excess of qualified stated interest*—(i) *Taxable bonds*—(A) *Bond premium deduction.* In the case of a taxable bond, if the bond premium allocable to an accrual period exceeds the qualified stated interest allocable to the accrual period, the excess is treated by the holder as a bond premium deduction under section 171(a)(1) for the accrual period. However, the amount treated as a bond premium deduction is limited to the amount by which the holder's total interest inclusions on the bond in prior accrual periods exceed the total amount treated by the holder as a bond premium deduction on the bond in prior accrual periods. A deduction determined under this paragraph (a)(4)(i)(A) is not subject to section 67 (the 2-percent floor on miscellaneous itemized deductions). See *Example 1* of § 1.171-3(e).

(B) *Carryforward.* If the bond premium allocable to an accrual period exceeds the sum of the qualified stated interest allocable to the accrual period and the amount treated as a deduction for the accrual period under paragraph (a)(4)(i)(A) of this section, the excess is carried forward to the next accrual period and is treated as bond premium allocable to that period.

(ii) *Tax-exempt obligations.* In the case of a tax-exempt obligation, if the bond premium allocable to an accrual period exceeds the qualified stated interest allocable to the accrual period, the excess is a nondeductible loss. If a regulated investment company (RIC) within the meaning of section 851 has excess bond premium for an accrual period that would be a nondeductible loss under the prior sentence, the RIC must use this excess bond premium to reduce its tax-exempt interest income on other tax-exempt obligations held during the accrual period.